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RECENT DECISIONS

Antitrust—Enforcement of Federal Trade Commission Orders

On January 16, 1959 the Federal Trade Commission issued a cease and desist order against Jantzen, Inc.. The FTC had charged that Jantzen was violating section 2 (d) of the Clayton Act by granting advantages to favored dealers. Jantzen consented to the issuance of the order without admitting that any violation had occurred. In 1964 the Commission, believing that Jantzen was not complying with the order, commenced proceedings in the Court of Appeals for the Ninth Circuit to enforce the order. Jantzen contended that the order was invalid, and that there was no method provided by law for its enforcement. *Held, dismissed*: The court has no jurisdiction to enforce the order. *FTC v. Jantzen, Inc.*, 356 F2d 253 (9th Cir. 1966).

Federal Trade Commission orders can issue for violations of either the Federal Trade Commission Act or the Clayton Act. Prior to 1938 the enforcement procedure was the same for orders under either act. Enforcement was achieved by applying to a federal court of appeals for a judicial decree ordering compliance. The initial order would be issued by the FTC for the first violation committed. In order to obtain a decree enforcing the FTC determination from the court of appeals, a second violation had to be shown. Once granted, the decree had the force and effect of an injunction, and if it was violated by a third illegal act the offender could be found to be in contempt. This enforcement procedure proved to be both time consuming and ineffective. Therefore, in 1938 Congress attempted to revise and improve this procedure by passage of the Wheeler-Lea Act.¹ This act amended section 5 of the Federal Trade Commission Act, but did not affect orders issued under the Clayton Act. In 1959 Congress passed the Clayton Finality Act² to modify and improve the enforcement procedure in regard to FTC orders issued for violations of the Clayton Act. It was intended to be similar to the earlier Wheeler-Lea Act. The Finality Act contained a paragraph relating to prior cases in which the court of appeals had issued an enforcement decree, but, unlike the Wheeler-Lea Act, it did not deal with cease and desist orders for which no enforcement decrees had been issued.

¹ 52 Stat. 111 (1938).

² 73 Stat. 243, 15 U.S.C. 21 (1959).

The failure to provide that such cease and desist orders would become final under the new section of the Clayton Finality Act seems to make all such orders presently unenforceable. As a consequence of this anomaly, the Federal Trade Commission tried to take the position that such cease and desist orders would, as provided in the Wheeler-Lea Act, become final sixty days after passage of the Clayton Finality Act. This contention was rejected in *Sperry Rand Corp. v. FTC*³. In the present case the FTC tried to go back and use the earlier method of enforcement by applying to the Court of Appeals for the Ninth Circuit for a decree enforcing the cease and desist order against Jantzen. The Ninth Circuit has replied that the earlier method is no longer available.

The instant decision has been the source of considerable concern in the Federal Trade Commission. "[T]he Commission asserts that, unless its views are accepted, 'forty-five years of Clayton Act enforcement and almost 400 orders to cease and desist would be wiped from the books'."⁴ To this argument the Court replied, "There is a presumption that people obey the law; we would suppose that it applies to obedience of FTC orders. The fact that there are 400 orders outstanding from forty-five years of enforcement, none of which the Commission has yet sought to enforce, is somewhat persuasive that the presumption is a valid one."⁵

J.M.W.

Community Property — Probate Code Section 46 — Williams v. McKnight

A husband and wife deposited \$10,000 of community funds in each of two bank accounts and a savings and loan account. Each deposit agreement provided that the funds would be owned in joint tenancy with right of survivorship. Upon the husband's death, the executor sued the widow to recover one half of the funds in each of the accounts which she had withdrawn after her husband's death. The widow contended that the deposit agreements constituted a partition of their community property under section 46 of the Probate Code. That section provides "that any husband and his wife may, by written agreement create a joint estate out of their community prop-

³ 288 F.2d 403 (1961).

⁴ *FTC v. Jantzen, Inc.*, 356 F.2d 253, 259 (9th Cir. 1966).

⁵ *Id.* at 260.

erty with rights of survivorship."¹ The trial court and the court of civil appeals² sustained that contention. *Held, reversed*: Section 46 is unconstitutional to the extent that it authorizes spouses to create by agreement a joint tenancy with rights of survivorship out of their community estate. *Williams v. McKnight*, 9 Tex. Sup. Ct. Jour. 376 (1966).

In 1948 the Texas Constitution was amended to allow partition of community into separate property.³ Pursuant to this amendment, article 4624(a) established a method by which partition could be accomplished.⁴ In 1961 the supreme court held in *Hilley v. Hilley*⁵ that to create a joint tenancy with right of survivorship out of community property, the property must first be transmuted into separate property prior to the agreement creating the joint tenancy. The legislature responded to *Hilley* by amending section 46 of the Probate Code⁶ to allow joint tenancies with right of survivorship. The instant case held that the attempt failed because the amendment did not provide for partition of the community property prior to the creation of the joint tenancy and that the holding in *Hilley* was controlling.

At first glance the court's objection to section 46 seems to be based on the narrow ground that the amendment did not contain the word partition. More likely, however, the court was struck with the contradiction which would arise from a construction of section 46 to allow *partition of community property into a joint tenancy*. In fact section 46 does not provide for a partition, and until there has been a partition, the community property has not changed its character. The importance of the concept of partition can be illustrated by supposing that the husband's creditor attempted to garnish the funds in the three accounts to satisfy the husband's obligation. There is little doubt that the creditor would prevail as against a claim by the wife that the agreement with the bank had partitioned the property and, therefore, one half of the funds were her separate property. The creditor need only point out that there had in fact been no partition.

The legislature has established procedures for partitioning community property. At present, the statutory formalities must be observed, and the partition must be effective before spouses may create joint tenancies with right of survivorship. Unquestionably the legislature could provide easier methods of partition, but legislative intent

¹ TEX. PROB. CODE ANN. § 46 (1956).

² *Williams v. McKnight*, 391 S.W.2d 813 (Tex. Civ. App. 1965), Note, 19 Sw. L.J. 865 (1966).

³ TEX. CONST. art. XVI, § 15 (1876).

⁴ TEX. REV. CIV. STAT. ANN. art. 4624(a) (1960).

⁵ *Hilley v. Hilley*, 161 Tex. 569, 342 S.W.2d 565 (1961).

⁶ TEX. PROB. CODE ANN. § 46 (1956).

to allow a *division* of the community must be clear before the court will find a change in the fundamental nature of the community estate.

J.L.P.

Discovery — Rule 186b — Limitations on Scope of Examination

Martha King and her husband instituted a suit in trespass against East Texas Salt Water Disposal. They alleged that oil in the reservoir beneath a tract leased by them had been displaced by water injected to the west of this tract by the defendant, rendering the wells on their tract unproductive. To obtain evidence to support their allegations, the Kings issued a subpoena duces tecum requiring the production of certain documents in the possession of Philip J. Lehnhard, Field Chairman for East Texas Engineering Association, an unincorporated association of certain producers in the East Texas Field. Neither Lehnhard, Engineering, nor any members of Engineering were parties to the main action. The documents sought to be produced consisted of reports, maps and data about the East Texas Field, assembled over a period of years by the members of Engineering. Engineering's bylaws provide that these documents are for the exclusive use of its members, and prohibit disclosure to nonmembers. The Kings contended that these documents were not only the best and most reliable source for the information sought, but that such information was not available from any source except Engineering. Lehnhard moved to quash the subpoena. District Judge David Moore denied the motion to quash but ordered some restrictions on the data which Lehnhard could be required to produce. Lehnhard then applied for a writ of mandamus in the Texas Supreme Court. He alleged that Judge Moore's orders constituted an abuse of discretion for which a writ of mandamus may issue, because the documents sought were not material and were confidential trade secrets which should be protected under rule 186b.¹ *Held, writ denied:* When a trial judge

¹TEX. R. CIV. P. ANN., 186b (1957).

After notice is served for taking a deposition on written interrogatories or by oral examination, upon motion seasonably made by any party or by the person to be examined and upon notice and for good cause shown, the court in which the action is pending may make an order that the deposition shall not be taken, or that it may be taken only before the court or at some designated place other than that stated in the notice or subpoena, or that it may be taken only on written interrogatories, or that it may be taken only by oral

determines that certain documents contain information which is material and necessary to a cause of action before the court, a disinterested person who has possession of these documents may in the discretion of the trial judge, be compelled to produce them. *Lebnhard v. Moore*, 9 Tex. Sup. Ct. J. 279 (1966).

The basic purposes of discovery are to narrow the issues before trial, to obtain evidence for use at the trial, and to secure information as to the existence of evidence that may be used at the trial and to ascertain how and from whom it may be procured.² By amending the discovery provisions of the Texas Rules of Civil Procedure, the supreme court has apparently implemented these broad purposes to their fullest degree. Under the rules, any person, whether or not a party, may be compelled to give a deposition or to produce documents and records about any matter not privileged. The information sought must be relevant to one of the purposes of discovery. The only express limitation upon the scope of discovery found in the rules protects an attorney's work product and the results of investigations by parties.³ All other limitations are discretionary with the trial judge.

A literal reading of the Texas discovery rules leaves it undisputed that a disinterested person can be compelled to testify and to produce documents and records. The supreme court's discussion in *Lebnhard* of the duty of a citizen to testify was merely in support of the rules which the court had promulgated. In *Lebnhard* the court upheld an order requiring a totally disinterested person to disclose information which although pertinent was not directly connected with the facts before the court. In so doing, the court brought Texas clearly in line with the liberal discovery practices of the federal courts,⁴ and demonstrated an unwillingness to prescribe any boundaries upon the discretionary authority of the trial judge.

D.E.W.

examination, or that certain matters shall not be inquired into, or that the examination shall be held with no one present except the witness and his counsel and the parties to the action and their officers and counsel, or that the deposition shall not be taken by or before the officer having the commission, or that after being sealed the deposition shall be opened only by order of the court, or that secret processes, developments or research need not be disclosed, or that the parties shall simultaneously file specified documents or information enclosed in sealed envelopes to be opened as directed by the court; or the court may make any other order which justice requires to protect the party or witness from undue annoyance, embarrassment, oppression, or expense.

² 2A BARRON AND HOLTZOFF, FEDERAL PRACTICE AND PROCEDURE 641 (1961).

³ TEX. R. CIV. P. ANN. 186a (1957).

⁴ See *Hickman v. Taylor*, 329 U.S. 495 (1947); *Hartley Pen Co. v. United States District Court for the Southern District of California, Central Division*, 287 F.2d 324 (9th Cir. 1961).

Habeas Corpus — State May Waive Requirement that Applicant Exhaust Available State Remedies

The appellant, Tolg, was arrested during a civil rights sit-in and convicted of violating a Georgia anti-trespass statute. Tolg's motion to arrest the judgment and his motion for new trial by which he attacked the constitutionality of the statute were overruled. Tolg did not file a bill of exceptions within the allowed time period, but the failure was not due to a willful intention to bypass state appellate procedure. Nor did appellant file a petition for state habeas corpus prior to the filing of his application for federal habeas corpus. A decision subsequent to Tolg's petition¹ for federal habeas corpus, *Hamm v. City of Rock Hill*,² giving the Civil Rights Act of 1964³ retroactive effect, arguably gave Tolg a state remedy not available at the time he filed his habeas corpus petition. The attorneys for the State of Georgia⁴ conceded that nothing would be gained by requiring Tolg to seek this remedy in the state courts.⁵ *Held*: The state may waive a habeas corpus applicant's failure to exhaust available state remedies if it recognizes, as it did here, that substantial justice will be furthered by such waiver. *Tolg v. Grimes*, 355 F.2d 92 (5th Cir. 1966).⁶

Section 2254 of title 28 of the United States Code⁷ states in pertinent part as follows: "An application for a writ of habeas corpus . . . shall not be granted unless it appears that the applicant has exhausted the remedies available in the courts of the State. . . ."⁸ The courts have consistently held that if a state prisoner has exhausted all the existing state remedies, but prior to the time he files for federal habeas corpus the Supreme Court makes a ruling which may change the state courts' policy toward the applicant's conviction, the

¹ United States *ex rel.* Tolg v. Grimes, 229 F. Supp. 289 (N.D. Ga. 1964). The court there found the petition to be without merit. This was prior to the *Hamm* decision, note 2 *infra*.

² 379 U.S. 306 (1964).

³ 78 Stat. 241, 42 U.S.C. 2000a (1964).

⁴ Grimes, the appellee, is the sheriff of Fulton County, Georgia.

⁵ The state said, "nothing would be gained by consuming the time and energy of counsel and the court by procedural shadow-boxing." Tolg v. Grimes, 355 F.2d 92, 97 (5th Cir. 1966).

⁶ The new remedy arose after appellant filed his habeas corpus petition, and the court stated that the right of the petitioner to proceed in federal district court must be determined as of the time the petition was filed. *Id.* at 98. The case was disposed of under the reasoning of *Hamm v. City of Rock Hill*, 379 U.S. 306 (1964), that if a conviction which is still pending is unconstitutional, as Tolg's was, it is void and of no effect. *Tolg*, 355 F.2d at 99.

⁷ 28 U.S.C. § 2254 (1964).

⁸ The statute continues to provide: "An applicant shall not be deemed to have exhausted the remedies available in the courts of the State . . . if he has the right under the law of the State to raise, by any available procedure, the question presented."

applicant has an additional state remedy which he must exhaust before the federal district court can consider his habeas corpus petition.⁹

Frequently, however, the available state remedy is narrowly construed,¹⁰ and the exhaustion of state remedies is but a futile technicality for gaining entry into the federal district court. The state, and the petitioner if he has hired counsel, therefore, is required to spend time and money presenting these cases to the state courts, although the case probably will return to the federal court once the formal need for exhaustion has been met.

If the state is reasonably certain that the petitioner cannot obtain relief in the state court, it can save itself the time and expense of defending the action by waiving the exhaustion requirement—allowing the federal district court to make immediate disposition of the case.¹¹ The majority of the court in *Tolg* reasoned that since the principle of exhaustion is a matter of comity and not a matter of jurisdiction, the state may waive exhaustion.¹² But did Congress intend to place the decision in the hands of state attorneys or did it intend for the applicant to get his answer as to whether a state remedy is available only from the state courts or the state statutes? This sparked Judge Bell to write a vigorous dissent. Judge Bell read section 2254 literally: "this statute speaks in terms of ' . . . shall not grant . . . ' and it contains no provision whereby counsel or a party may invest the court with authority to grant the writ."¹³ "Now the lawyers will decide which court may act."¹⁴

If there is a state remedy presently available, and if the state demands that the federal habeas applicant exhaust this remedy, the

⁹ *Blair v. California*, 340 F.2d 741, 745 (9th Cir. 1965); and *cf.* *Cyronne-DeVirgin v. Missouri*, 341 F.2d 568 (8th Cir. 1965). *Contra* if the state courts recognize the new right but refuse to give it retroactive effect. *United States ex rel. Mancini v. Rundle*, 337 F.2d 268, 271 (3d Cir. 1964).

¹⁰ In Georgia, state habeas corpus generally is not available to raise an issue which has been foreclosed by failure to raise a timely appeal. See *Cobb v. Balkcom*, 339 F.2d 95 (5th Cir. 1964). In Texas, habeas corpus usually is available only to test a conviction under an invalid law or under no law at all. See *Ex parte Wynn*, 158 Tex. Crim. 665, 259 S.W.2d 191 (1953); *Cofer, Observations on Habeas Corpus and Post-Conviction Relief in State and Federal Courts*, 28 Tex. B.J. 947, 996 (1965).

¹¹ There are other reasons why the state may prefer to have the federal court decide prior to the exhaustion of state remedies: it may believe it can win on the merits, or it may feel that the petitioner has a valid claim and should receive prompt relief. It must be remembered that *Tolg* will apply only when justice will be furthered by such waiver, and financial reasons alone would not meet this test.

¹² Some years ago Mr. Justice Rutledge argued for the same type of result: The absolute requirement of exhaustion of state remedies "would be nothing less than abdication of our constitutional duty and would function to rebuff petitioners with this mechanical formula whenever it may become clear that the alleged state remedy is nothing but a procedural morass offering no substantial hope of relief." *Marino v. Ragen*, 332 U.S. 561, 564 (1947) (concurring opinion).

¹³ 355 F.2d at 100.

¹⁴ *Ibid.*

federal district judge undoubtedly will give the state courts the first opportunity to act upon the claim. Even if the state does wish to waive the requirement of exhaustion, the federal district judge may deny the state's request because he feels substantial justice will not be furthered by such waiver.

The result in *Tolg* does not increase federal-state frictions since the waiver of exhaustion is placed in the hands of state officials. On the other hand, the states may be tempted to shirk their responsibility to provide adequate state post-conviction relief.

J.B.H.

Procedure — Finality of Judgements — Appeal

ALDRIDGE was sued by the North East Independent School District for the breach of a construction contract. Aldridge claimed that he acted only as agent in executing the contract, and that his principal was King-O-Hills Development Company. With the permission of the trial court, Aldridge filed a cross-action against King-O-Hills to recover any sum which he might be adjudged liable to pay to the School District. The trial court held that Aldridge was liable for damages. In the judgment no mention was made of the cross-action against King-O-Hills. Aldridge's appeal from the trial court's judgment was dismissed by the court of civil appeals on the ground that the judgment appealed from was not final in that no disposition was made of the cross-action.¹ *Held, reversed*: "When a judgment, not intrinsically interlocutory in character, is rendered and entered in a case regularly set for a conventional trial on the merits, no order for a separate trial of issues having been entered pursuant to Rule 174 . . . it will be presumed for appeal purposes that the Court intended to, and did, dispose of all parties legally before it and of all issues made by the pleading between such parties." The judgment appealed from was final. *North East Independent School District v. Aldridge*, 400 S.W.2d 893 (Tex. 1966).

The early Texas rule for determining the finality of judgments was that "the judgment must in substance show intrinsically, and not inferentially, that the matters in the record had been determined in favor of one of the litigants, or the rights of the parties in litiga-

¹ *Aldridge v. North East Independent School District*, 392 S.W.2d 607 (Tex. Civ. App. 1965).

tion had been adjudicated.”² This rule was changed in favor of a presumption that the trial court had disposed of all issues in the pleadings.³ Some confusion existed with regard to whether the presumption extended to the manner in which the issues were disposed of, e.g., whether a particular issue was denied or dismissed.⁴ Under the rule established in the instant case, the presumption is only that the trial court *disposed* of the issues and the parties before it.

The court expressly made the rule subject to the exception created by *Davis v. McCray Refrigerator Sales Corp.*⁵ The exception is stated: “It will not be presumed that a judgment dismissing a plaintiff’s suit on non-suit, plea to the jurisdiction, plea in abatement, for want of prosecution, etc., also disposed of the issues in an independent cross-action.”⁶ The problem of finality of judgments is usually created by careless draftmanship. The presumption that the trial court disposed of all the issues and parties before it is a logical one. On the other hand the presumption is not applicable in the *Davis* situation because “if the trial court intended to retain the cross-action for further consideration, it would have entered the very judgment which it did enter in granting a non-suit.”⁷ The use of the presumption established in this case should remove much of the confusion in determining when a judgment is final for purposes of appeal.

G.M.L.

Procedure — Time Limits for Perfecting Appeals

Frizzel brought suit against Puckett to reform a deed. The trial court granted judgment for the plaintiff. Notice of appeal was contained in the judgment entered on November 13. On November 20, the defendant filed a motion for new trial which was overruled on December 17. On January 14, within thirty days from the overruling of the motion for new trial but not within thirty days from entry of judgment containing the notice of appeal, the defendant put up cash in lieu of an appeal bond. On February 25, the court of civil appeals granted the appellant an additional twenty days within which to file the record. The record was filed on March 8, within the twenty-

² *Linn v. Arambould*, 55 Tex. 611, 619 (1881).

³ *Trammell v. Rosen*, 106 Tex. 132, 157 S.W. 1161 (1913).

⁴ *Burton Lingo Co. v. First Baptist Church of Abilene*, 222 S.W. 203 (Tex. Comm. App. 1920).

⁵ 136 Tex. 296, 150 S.W.2d 377 (1941).

⁶ *North East Independent School District v. Aldridge*, 400 S.W.2d 893 (Tex. 1966).

⁷ *Id.* at 897.

day extension. The court of civil appeals dismissed the appeal for want of jurisdiction because the appeal bond and the record were not timely filed.¹ The question before the supreme court was whether the dismissal of the appeal was proper. *Held, reversed*: Where the judgment contains a notice of appeal and there is a motion for new trial which is overruled, the time limits for posting an appeal bond, or cash in lieu of a bond, and for filing the record run from the order overruling the motion for new trial. *Puckett v. Frizzell*, 9 Tex. Sup Ct. Jour. 347 (1966).

Timely filing of the appeal bond is jurisdictional.² Rule 356 requires that a cost bond or cash in lieu of bond be filed "within thirty days after rendition of judgment or order overruling motion for new trial. . . ."³ Rule 306(c) provides that every notice of appeal is considered filed "on the date of . . . the rendition of judgment . . . , or from the date of the overruling of motion for new trial, if such motion is filed."⁴ The court of civil appeals reasoned that the notice of appeal would date from the overruling of a motion for new trial if an additional notice of appeal had been given. The supreme court observed that while the notice of appeal was only an appeal from the judgment rendered and not an appeal from the overruling of the motion for new trial, nevertheless, the notice of appeal given at the time of judgment was effective for purposes of the time limits from the time of the overruling of the motion for new trial.

An appellant to perfect an appeal must timely file a notice of appeal and a bond.⁵ Certainty is required in the rules in order that an appellant is not deprived of his rights because of confusion with regard to when the time limits begin to run. The decision in the instant case clarifies language in the rules which is subject to varying interpretations and provides a definitive construction.

G.M.L.

Restitution — Defaulting Purchaser

Plaintiff contracted to purchase a tract of land from the defendant. While no payments had been made on time, by July 6, 1961 the plaintiff had paid \$1,070 of the \$1,500 consideration promised. This

¹ *Puckett v. Frizzell*, 396 S.W.2d 245 (Tex. Civ. App. 1965).

² *Hamilton v. Empire Gas & Fuel Co.*, 134 Tex. 377, 110 S.W.2d 561 (1937).

³ TEX. R. CIV. P. 353(a).

⁴ TEX. R. CIV. P. 306(c).

⁵ See note 4 *supra*.

left a balance of \$430 unpaid and overdue since April 1, 1961. On February 1, 1962 the defendant conveyed the land by general warranty deed to a bona fide purchaser¹ for a consideration of \$1,300. Plaintiff brought an action seeking restitution for the payments of \$1,070 made under the contract. The trial court awarded the plaintiff \$1,070 plus interest from the date of sale by the defendant to the bona fide purchaser. On appeal, the defendant contended that the plaintiff had defaulted on the contract since he had made his payments late, and therefore, all of the payments were forfeited. *Held, affirmed as modified*: Where the vendor elects to exercise his power to terminate a contract for the sale of land, he is entitled to damages for the breach of the contract. The defaulting purchaser is entitled under equitable principles to restitution of the purchase money paid diminished by the damages suffered by the vendor. *De Leon v. Aldrete*, 398 S.W. 2d 160 (Tex. Civ. App. 1966).

The majority of the jurisdictions in this country, departing from the English rule that a defaulting purchaser is entitled to recover payments made to the vendor under the contract,² hold that upon effective termination by the vendor, all payments by the defaulting purchaser are forfeited.³ The rationale of this rule is that a vendee should not be able to create his own cause of action for restitution due to his own breach of the purchase contract.⁴ The harshness of the rule, however, has caused many courts to seize upon any plausible ground available to avoid it, particularly where the purchaser's default was not willful.⁵

In the instant case the court recognized some broad language in the Texas decisions⁶ which indicated a commitment to the forfeiture rule, but pointed out that the better Texas authority⁷ recognizes that the

¹ The contract between plaintiff and defendant was not recorded, and the plaintiff never took possession of the land.

² *Palmer v. Temple*, 9 Ad. & El. 508, 112 Eng. Reprint 1304 (1839). The rationale of the rule is that when the contract is abandoned on both sides, the idea of payment is necessarily abandoned. The vendor is then in the situation of retaining money under circumstances not provided for, and thus holds the money to the use of the vendee. This rule does not apply to "earnest" money.

³ Annot., 31 A.L.R.2d 8, 11-12 (1953).

⁴ *Ibid.* See also *Estes v. Browning*, 11 Tex. 237 (1853).

⁵ *Tucker v. Beam*, 343 Ill. App. 290, 98 N.E.2d 871 (1951); *Malberg v. Baugh*, 62 Utah 331, 218 P. 975 (1923).

⁶ *Tom v. Wollhoefer*, 61 Tex. 277 (1884); *Estes v. Browning*, 11 Tex. 237 (1853); *Magruder v. Poulton*, 257 S.W. 533 (Tex. Comm. App. 1924).

⁷ *Lipscomb v. Fugua*, 103 Tex. 585, 131 S.W. 1061 (1910). In this case, after paying \$10,000, which was to be forfeited upon failure to perform, plaintiff took possession of the land. Plaintiff later defaulted on the payments due and defendant, vendor, evicted him. The court stated that whether a vendor who "rescinds" an executory contract for the sale of land shall return the purchase money paid depends on the equities of each case. Here no equities were found in plaintiff's favor. See also *Miller v. Horn*, 149 S.W. 769 (Tex. Civ. App. 1912); *Fink v. Hough*, 153 S.W. 676 (Tex. Civ. App. 1913) *error ref.* *Cf.* *Sparenburg v. Collins*, 63 S.W.2d 241 (Tex. Civ. App. 1933).

vendor may be required to make restitution, depending on the equities of each case. The court considered an absolute rule of forfeiture completely unreasonable because it disregards the amount of damage suffered by the vendor. Also, the payments forfeited by the purchaser increase as the seriousness of his breach decreases.

The court pointed out that the purchaser's breach did not in itself terminate the contract, and his right to restitution cannot arise unless the vendor elects to reject his remedies of specific performance or foreclosure and exercises his power to terminate the contract for all purposes. If the vendor chooses to terminate and thus disable himself from performing under the contract, equity requires, at least in the absence of a forfeiture clause, that the vendor hold the payments made to the use of the purchaser subject to allowance for proper damages. Here the defendant was found to be damaged to the extent of \$200, the difference between the contract price of \$1,500, and the sale price of \$1,300. The vendor's damages were fixed at the date of sale to the third party. The purchaser recovered \$870 which consisted of his payments of \$1,070 diminished by \$200 plus interest from the date that the vendor terminated the contract.

A surprisingly small amount of litigation has arisen in this area. One reason may be a preference of vendors to affirm the contract and to sue for specific performance or to seek foreclosure.⁸ Another seemingly apparent reason would be the inclusion of a forfeiture clause in the contract. Whether such a clause automatically precludes restitution is not certain. The court in the instant case, while not presented with the question, suggests that a forfeiture clause would control.⁹ However, there is authority which indicates that a forfeiture clause would not control if the equities were in favor of the defaulting purchaser.¹⁰

R.B.D.

Taxation — Grant of Formulas — Ordinary Income

James H. Pickren and Arthur Hooker were joint owners of certain secret formulas and trade names that were indisputably capital assets in their hands. In 1957 they entered into a contract granting Freit Laboratories, Inc. "the exclusive right and license, for a period of

⁸ See *Huddle v. Cleveland*, 297 S.W.2d 737, 740 (Tex. Civ. App. 1957), for a discussion of the remedies available to the vendor.

⁹ 398 S.W.2d 160, 164 (Tex. Civ. App. 1965).

¹⁰ See note 7 *supra*.

twenty-five years" to manufacture the products derived from the formulas and the right to use the trade names. Pickren included amounts received from Freit under this contract as long term capital gains in his tax returns for 1959, 1960 and 1961. The Commissioner asserted that these payments represented ordinary income because there had been no "sale" of a capital asset.¹ *Held*: Since the full rights to the formula and trade names would revert to the taxpayer at the expiration of twenty-five years, the taxpayer had not completed a sale of all substantial rights in the assets. Therefore, the taxpayer must report his proceeds as ordinary income. *Pickren v. United States* 249 F. Supp. 560 (D.C. Fla. 1965).

Although this was a case of first impression, prior cases concerning patents furnish an excellent analogy. The crucial question in determining if the taxpayer has ordinary income or capital gains is whether there has been a "sale." The decisions in *Estate of Gowdey v. Commissioner*² and *Thomas D. Armour v. Commissioner*³ appear to set out the controlling principles in delineating a "sale" involving patent rights or trade names. In the *Gowdey* case the taxpayer obtained a limited patent license for a product called "Dairy Queen." Gowdey then entered into fourteen "Franchise Agreements" for various territories in Virginia. Each licensee received in perpetuity the exclusive rights to use the patented machine, to use the name "Dairy Queen" and, to prepare and sell the secret-mix frozen product in a specified territory. By express provision in the agreement, Gowdey retained title to all machines. The Tax Court found that these agreements were not sales but rather mere licenses and therefore Gowdey's proceeds were ordinary income.⁴ The Fourth Circuit reversed and held that these exclusive rights were capable of sale without also selling the machines and had in fact been sold thereby entitling the taxpayer to capital gains. The court stated, "A predominant factor in our determination—that the franchise agreements accomplished a sale—is that the privileges were transferred in perpetuity."⁵

The decision in *Armour* illustrates the other side of the coin. In that case the taxpayer sold the exclusive right, license and privilege to use the name "Tommy Armour" as a trade mark on golf balls. This privilege, initially granted for a term of years, was to exist "from this date forth." The Tax Court decided that the taxpayer

¹ INT. REV. CODE OF 1954, § 1222(3).

² 307 F.2d 816 (4th Cir. 1962).

³ 22 T.C. 181 (1954).

⁴ *Estate of G. R. Gowdey*, 1961 P-H Tax Ct. Mem. ¶ 61,112 (1961).

⁵ 307 F.2d at 820.

had not granted the perpetual right to use his name and therefore the proceeds were ordinary income.

The *Pickren* case is the first decision to apply the "sale" test to a secret formula situation. Apparently the most important factor in meeting this test is that some right be granted "in perpetuity." Could it be argued that a transfer for a term of years would be a sale of all or substantially all of the rights in a secret formula if the interest retained was of insubstantial value? The court's opinion in *Pickren* leaves this question unanswered.

J.M.W.

Taxation — Section 1221(1) — Property Held Primarily for Sale

William Malat was a participant in a joint venture which acquired a forty-five acre parcel of land. Because of difficulties in developing the property, the joint venturers sold their interests in part of the acreage and reported the proceeds as long-term capital gains. At the time of acquisition and during the period the property was held, the participants had a dual purpose of either developing the land as rental property and holding it as an investment, or developing the land for sale, whichever would be more profitable. A deficiency was assessed by the Commisisoner who asserted that the property was held "primarily for sale to customers in the ordinary course of his trade or business,"¹ and therefore was not a capital asset. The taxpayer paid the assessment and sued for a refund. The district court sustained the Commissioner, and the court of appeals affirmed. The Supreme Court granted certiorari "to resolve a conflict among the Courts of Appeals with regard to the meaning of the term 'primarily' as it is used in § 1221(1) of the Internal Revenue Code of 1954." *Held, vacated and remanded*: "As used in § 1221(1), 'primarily' means 'of first importance' or 'principally.'" *Malat v. Riddell*, 86 Sup. Ct. 1030 (1966).

Section 1221(1) reads, "For purposes of this subtitle, the term 'capital asset' means property held by the taxpayer (whether or not connected with his trade or business), but does not include—(1) . . . property held by the taxpayer *primarily* for sale to customers in the ordinary course of his trade or business." The courts of appeals have

¹ INT. REV. CODE OF 1954, § 1221(1).

interpreted "primarily" in two ways. The Second² and the Ninth³ Circuits have construed it to mean "substantially." Thus, if a taxpayer acquired and held property for the dual purpose of investment and for sale to customers, under the substantial test the property was held primarily for sale, and therefore was not a capital asset. The Fifth⁴ and Eighth⁵ Circuits have followed a construction which was adopted by the Supreme Court in the instant case. In *Municipal Bond Corporation v. Commissioner*⁶ the Court of Appeals for the Fifth Circuit reversed a Tax Court finding that "while the sales purpose, in some instances may not have been predominant over the investment purpose, it was, nevertheless, substantial throughout the entire period under review." The court said that the Tax Court should have based its finding "on a determination of the primary or predominant purpose of taxpayer in acquiring and holding the properties."

The Supreme Court reasoned that "primarily" should be interpreted in its "ordinary, everyday sense." While the holding is expressly limited to section 1221(1), it seems likely that the same meaning of "primarily" is intended in section 1231 (relating to property used in trade or business and involuntary conversions) and section 1237 (relating to real property subdivided for sale). At the same time, the Court made no attempt to resolve other difficulties in section 1221(1). For example the phrase "in the ordinary course of . . . business" has been the subject of varying interpretations. *Malat*, however, may be construed as placing the emphasis on the taxpayer's intent during the holding period. If the courts of appeals adopt this construction, cases which have concerned themselves with the extent of the taxpayer's activities at the time of sale will lose their vitality.⁷

G.M.L.

Taxation — Subchapter S — Classes of Stock

Gamman and Reese, petitioners, organized Century House, Inc., which was incorporated in Washington on October 15, 1959, to con-

² *American Can Co. v. Commissioner*, 317 F.2d 604 (2d Cir. 1963).

³ *Rollingwood Corp. v. Commissioner*, 190 F.2d 263 (9th Cir. 1951).

⁴ *United States v. Bennett*, 186 F.2d 407 (5th Cir. 1961).

⁵ *Municipal Bond Corp. v. Commissioner*, 341 F.2d 683 (8th Cir. 1965).

⁶ *Ibid.*

⁷ See *Achong v. Commissioner*, 246 F.2d 445 (9th Cir. 1957); *Palos Verdes Corp. v. United States*, 201 F.2d 256 (9th Cir. 1952); and *Snell v. Commissioner*, 97 F.2d 891 (5th Cir. 1938).

struct a motel near the site of the World's Fair in Seattle. Petitioners were equal owners of all the 400 outstanding shares of no-par common stock of the corporation. The corporation's books showed paid-in capital of \$400 for the years in question.¹ At the end of 1961 the petitioners had advanced \$165,670.80 to the corporation; by the end of 1962 they had advanced a total of \$252,343.80 in approximately equal amounts from each. These advances were evidenced by six per cent demand notes, on which petitioners had waived the interest due and had made no demand for payment. On January 25, 1961 Century House with the consent of all its shareholders filed an election under subchapter S.² In 1961 and 1962 Gamman and Reese claimed as deductions on their individual income tax returns their pro rata share of the operating losses of Century House. The Commissioner disallowed the deductions on the ground that the advances made by petitioners to the corporation constituted a second class of stock, as a result of which Century House did not qualify as a small business corporation under section 1371(a) of the Code.³ *Held*: The notes although representing equity or risk capital did not give the holders of the notes any rights and interests in the corporation different from their rights and interests as owners of all the capital stock of the corporation. Therefore, the notes did not constitute a second class of stock. *W. C. Gamman*, 46 T.C.—No. 1 (1966).

The Commissioner's argument that the promissory notes issued to the shareholders in return for their advances to the corporation actually constituted a six per cent preferred nonvoting stock was based on the provision that "if an instrument purporting to be a debt obligation is actually stock, it will constitute a second class of stock."⁴ Section 1731(a) of the Code defines the term "small business corporation" *inter alia*, as a domestic corporation which does not have more than one class of stock. The Tax Court nullified the regulation relied on by the Commissioner because it was too broad and placed "a restriction on the stockholders of electing corporations which was not intended by Congress." The court went on and looked at "the realities of the situation" to determine that the advances *were* addi-

¹ The years in question here are 1961 and 1962. From the date of incorporation, in October 1959, to January 1960, there was another stockholder of the corporation, but in 1960 he was bought out by the corporation which also paid off his advances without interest. In 1964 the corporation recapitalized and a substantial portion of the advances made by the stockholders was converted into additional stock, bonds, and paid-in capital of the corporation. However, the court limited its consideration to the facts and circumstances as they existed in 1961 and 1962.

² INT. REV. CODE OF 1954, § 1372(a).

³ All section references are to the Internal Revenue Code of 1954 unless otherwise indicated.

⁴ Treas. Reg. § 1.1371-1(g) (1958).

tions to capital which were "placed at the risk of the business just the same as the amounts petitioners paid for the capital stock." However, it did not matter in this case that the advances were additions to capital rather than loans because the instruments did not give the petitioners any rights and interests in the income and assets of the corporation different from the rights and interests they had as owners of all the capital stock. Any preferences given by the notes were preferences only over the noteholders themselves as stockholders. Thus, the court held that Century House did not have more than one class of stock within the meaning of section 1371.

Five judges concurred in the result and five judges dissented. Three who concurred thought that there was only one class of stock but that the regulation required this conclusion. They thought that the notes "were not 'actually stock' under any theory" because under the regulation "the elements of character of the so-called debt obligation must be the same as the elements characterizing a share of stock." The two other concurring judges said that the legislative history showed that the single class of stock requirement was imposed to avoid the necessity for complex rules of allocation. Therefore, they thought the second class of stock doctrine, as stated in the regulations, was inconsistent with the intent of Congress and might produce grave inequities that were not contemplated. The five dissenters thought that the instruments did establish different rights and liabilities from those associated with the corporation's common stock even though there was no intention to enforce the notes according to their terms. They felt that the notes resembled cumulative, nonparticipating, redeemable preferred stock, and that if they had been so labeled, there would have been no question that they constituted a second class of stock.

*W. C. Gamman*⁵ should be read together with three recent cases dealing with the same issue.⁶ In *Catalina Homes, Inc.*⁷ the court held that advances constituted a second class of stock for purposes of section 1371(a). There the court found that the advances were not represented by notes or any other evidence of indebtedness, that interest was payable as determined by the board of directors, that there was "thin incorporation," and that the advances were preferred over the no-par common stock to the extent that dividends could not be paid on the no-par common stock until the advances

⁵ 46 T.C. ___, No. 1 (1966).

⁶ The issue in each case was whether advances made to the corporation constituted a second class of stock and therefore disqualified the corporation's subchapter S election under section 1372(a).

⁷ 23 CCH Tax Ct. Mem. 225 (1964).

plus interest had been paid in full. However, the court did not look at "the realities of the situation" to determine whether the advances by the shareholders actually gave them any rights and interests different from their rights and interests as holders of the common stock. In *Seven Sixty Ranch Co. v. Kennedy*⁸ a district court held that notes given by the corporation to its sole shareholder evidencing loans made by him to the corporation did not constitute a second class of stock. There the court found that the shareholder had actually created a genuine debtor-creditor relationship between himself and the corporation; and that he did not acquire, by virtue of having made the loans to the corporation, an advantage or superior right to participate in the management of the corporation as *he was at all times the sole operator and manager*. The reasoning here seems to be the same as that of *W. C. Gamman*, in that the court thought that any preferences given by the notes were preferences only over the noteholder himself as the sole stockholder. In *Henderson v. United States*,⁹ now on appeal to the Fifth Circuit, the district court found that the advances represented a capital investment rather than a debt investment and held that the instruments evidencing the advances constituted a second class of stock. There, as in *W. C. Gamman*, there was no attempt by the noteholder to enforce the instruments in accordance with their terms. Other factors lead the court to the conclusion that the loans were intended to be equity or risk capital.

Any further action by the Commissioner in this area will probably await the outcome of the appeal of *Henderson* in the Fifth Circuit. While no prediction of the outcome will be made, it seems that the result reached by the Tax Court in *W. C. Gamman* is more in line with the intent of Congress in providing the subchapter S election for "small businesses," to permit them "to select the form of business organization desired, without the necessity of taking into account major differences in tax consequences."¹⁰

W. T. H.

⁸ CCH 1966 STAND. FED. TAX REP. ¶ 9293 (66-1 U.S. Tax Cas.) (D. Wyo. 1966).

⁹ 245 F. Supp. 782 (D. Ala. 1965), *appeal docketed* (5th Cir.).

¹⁰ S. Rep. No. 1983, 85th Cong., 2d Sess. 4876 (1958); 1958-3 Cum. Bull. 1008; 1964-1 Cum. Bull. (2) 650.

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